2. Euro area and the monetary policy of the Eurosystem

The sovereign debt crisis in the euro area worsened, triggering negative spillover effects between the state of public finances in various countries, the situation of financial institutions, and the economic climate. After remaining vigorous in the first quarter of 2011, GDP growth slowed considerably. Most of the countries which had been forced by the 2008-2009 crisis to rectify their imbalances continued to record below-average growth rates. Since the financial markets doubted the sustainability of the public debt of some of those countries, they were obliged to undertake rigorous fiscal consolidation. The ECB Governing Council, which had responded to inflationary pressures in the first part of the year, then cut the key interest rates in view of the deteriorating economic outlook and the associated decline in inflation risks. It maintained the non-conventional measures to safeguard the transmission of monetary policy in the first half of the year, and actually reinforced them in the second half.

2.1 The sovereign debt crisis in the euro area

In 2011, the euro area entered a new phase in the sovereign debt crisis. There was a further heightening of financial market tension, especially from the summer. The contagion between Member States spread further, whereas negative feedback effects between fears over the stability of the financial sector and concern for the sustainability of public finances increased. The sovereign debt crisis, which was itself due partly to the financial crisis, had a steadily worsening impact on the financial sector, while the latter's problems in turn weighed on expectations regarding public finances.

At the end of 2009, the interest rate differential between Greek government bonds and the German Bund had begun to widen. The substantial upward revision of the Greek public deficit in October 2009 had fuelled doubts about the reliability of the statistics and concern about the sustainability of Greece's public debt. In the first quarter of 2010, the spread between Greek and German interest rates widened further, and the financial turmoil extended to other vulnerable countries in the euro area which, in varying degrees, combined a large public debt with chronic current account deficits and structural competitiveness problems (this applied to Portugal, Spain and, to a lesser extent, Italy), or whose particularly fragile banking system could endanger the fiscal position (as in the case of Ireland). In 2011, sovereign yield spreads compared to the German Bund widened still further, and contagion worsened in the euro area.

The cross-border extension of the crisis showed that the lack of confidence on the financial markets was not confined to the viability of public finances in a few countries, but that the doubts extended to the smooth functioning of Economic and Monetary Union itself. European economic governance had not in fact managed to prevent the emergence of serious internal and external macroeconomic imbalances in a number of countries, in particular excessive public and private debt levels. The instability of one country infected others owing to the close economic and financial integration of the euro area.

It is true that, in the years preceding the financial crisis which began in mid-2007, macroeconomic divergences had developed in the euro area. Labour costs and domestic

demand had risen very strongly in certain countries, such as Ireland, Spain and Greece, and that expansion was accompanied by sustained growth of lending to households and substantial, persistent increases in property prices. These striking disparities in the movement in domestic demand and competitiveness had caused a clear divergence between euro area countries in current account balances. Moreover, the public finances of certain countries, mainly Greece, had long been in a precarious position.

When the financial crisis became a global economic crisis in the autumn of 2008, public finances clearly suffered. Apart from the operation of the automatic stabilisers, recovery plans were adopted to try to stave off the collapse of economic activity. In several countries, the government also had to intervene to support the banks. Countries with a financial sector seriously exposed to risks, such as Ireland, suffered a very severe deterioration in their public finances. More generally, countries whose growth had been based too much on debt had to initiate an adjustment process leading to a contraction of domestic demand, which depressed activity. In this worsening situation, financial operators became more worried about the sustainability of the public debt, and in the end doubted the stability and cohesion of the euro area as a whole.

In response to these events, the European authorities acting in cooperation with the IMF adopted various measures to control the debt crisis. In May 2010, aid for Greece was agreed in the form of bilateral emergency funding of € 110 billion, of which € 30 billion was to come from the IMF. The Council of Ministers also decided to create the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF), with financial resources totalling € 500 billion. The IMF was closely associated with these two mechanisms and contributed an extra € 250 billion.

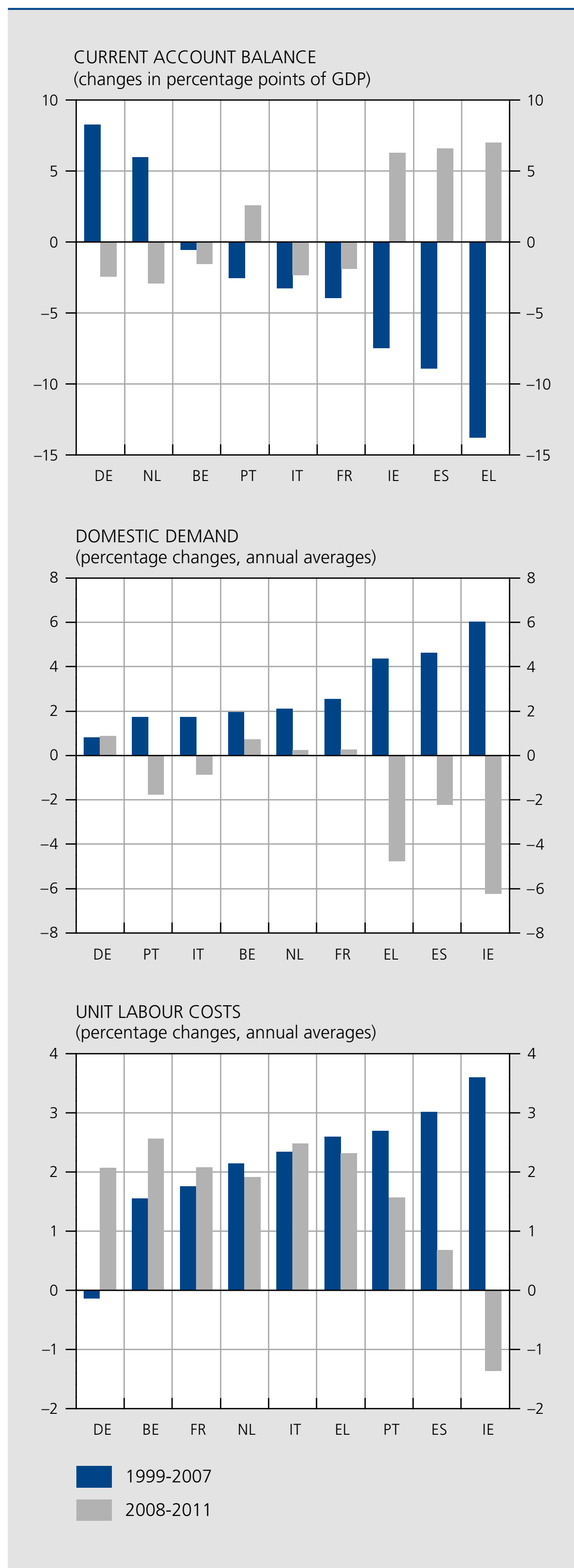
In 2010, the European Council also set up a task force, chaired by Herman Van Rompuy, to draw up proposals, in cooperation with the EC, for strengthening fiscal discipline and the coordination of economic policies. In September 2011, after intense negotiations, the European Parliament adopted the six legislative proposals (the Six Pack) resulting from this work, and the Ecofin Council then gave its approval on 4 October 2011. The new European rules on economic governance imply a radical change to the fiscal rules. Both the preventive and the corrective rules of the Stability and Growth Pact are reinforced, the decision-making procedures are modified and minimum requirements are imposed on the national budgetary frameworks of the Member States. Two of the six texts concern the prevention and correction of macroeconomic imbalances. They also provide for sanctions for euro area Member States. In March 2011, the Heads of State or Government of the euro area and of six other EU countries also concluded a Euro Plus Pact which aims to coordinate economic policies still further, in order to enhance the competitiveness of the national economies and their convergence.

In its final report, the task force on economic governance also expressed the view that the euro area should, in the medium term, set up a credible crisis resolution framework. That recommendation was approved by the European Council in October 2010. In March 2011, the euro area Heads of State or Government adopted the main features of the European Stability Mechanism (ESM), which would take over the role of the EFSF and the EFSM from July 2013 in granting financial aid to euro area Member States. The effective lending capacity of the ESM was to be € 500 billion. It should be able to activate a stability support mechanism in the short or medium term for any euro area Member State in serious financial difficulties, and to purchase that State's bonds on the primary market. It was also planned that, if a Member State received financial assistance, the private sector should be required to make an adequate and proportionate contribution.

Despite these measures, and partly because of the announcement, from October 2010, that the private sector might be involved, tensions continued to mount in 2010 and 2011. The further deterioration in public finances and the growing concerns about the sustainability of the budgets, plus the increasingly intense speculation on the financial markets regarding a possible restructuring of the Greek public debt, added further fuel to the anxiety. In November 2010, the Irish government accepted a financial package worth € 85 billion, comprising a series of loans from the EFSM, the EFSF, the IMF and the United Kingdom, Sweden and Denmark, for a total of € 67.5 billion, the balance being financed by Ireland itself, mainly out of its national pension fund. In May 2011, Portugal received financial assistance totalling € 78 billion, of which € 26 billion came from the IMF and € 52 billion from the European emergency funds. However, all these measures only managed to reassure the financial markets temporarily.

During the summer of 2011, the financial market turbulence further intensified, owing to the uncertainty over the continuation of the consolidation of public finances, the authorities' reaction to the euro area debt crisis – deemed too little, too late – and the deteriorating economic outlook. Spreads between the yields on Greek and German government bonds continued to widen significantly, as the sustainability of the Greek public debt gave ever more

CHART 10 MACROECONOMIC IMBALANCES IN THE EURO AREA (1)



Source: EC.
(1) The chart only shows the six countries with the largest GDP and the three countries which received conditional financial assistance from the EU and the IMF in 2011. The countries are ranked on the basis of the data for the period 1999-2007.

cause for concern, in view of the delay in implementing the adjustment programme to which Greece had committed itself, and steadily worsening growth expectations for that country's economy. At the same time, the contagion on the government bond markets had spread further. Thus, the Italian and Spanish markets for government securities were increasingly affected, also contaminating the Belgian market in government bonds.

Against the backdrop of tension on the Italian and Spanish markets in public debt securities, decisions were passed at the European summit on 21 July 2011 to ensure the sustainability of Greek public finances and to stop the crisis from spreading. Since Greece could not return as a borrower on the financial markets in 2012, the euro area Heads of State or Government planned a second aid programme for that country. It comprised new official funding of around € 109 billion, the loans to Greece – like those to Ireland and Portugal – being granted under more favourable conditions in terms of maturity and interest rates. Moreover, the financial sector was prepared to offer Greece voluntary support. It was also decided to increase the flexibility of the EFSF and the ESM, which will be able to act, for instance, under a precautionary programme, to finance the recapitalisation of financial institutions through loans to governments, and to intervene on the secondary markets. As explained below, the ECB Governing Council also adopted supplementary measures to ensure the transmission of monetary policy in a climate of serious financial tensions.

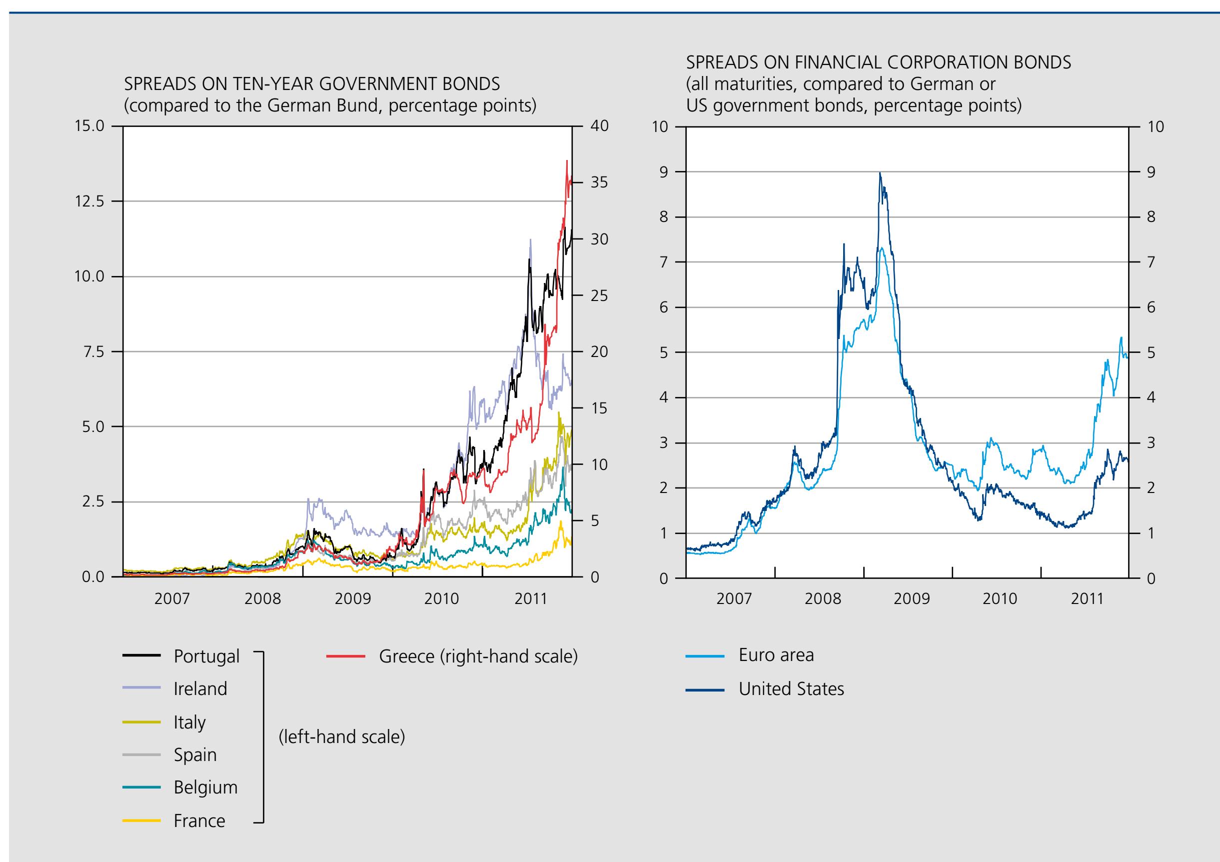
However, these decisions and measures brought only temporary calm to the financial markets, partly because of the time required for the 17 euro area countries to obtain parliamentary approval. In addition, the financial markets were not convinced that the measures would be sufficient to control the crisis. Inadequate communication, and even contradictory statements by the European decision-makers, plus numerous grey areas in the agreement were part of the reason. Moreover, the agreement on the financial sector's voluntary contribution for Greece undermined the belief that government securities of advanced economies are risk-free. The markets also feared that this contribution might create a precedent. In addition, the 21 July agreement failed to eliminate doubts over the sustainability of the Greek public debt. The new official funding was not activated. Greece appeared to be locked in a negative spiral, with a steeper-than-expected decline in economic growth and the need for ever bigger savings and tax increases to achieve the budget targets, so that more substantial sovereign debt relief seemed to be the only solution. In the ensuing months, the debt crisis in the euro area escalated. Spreads in relation to the yield on the German Bund widened dramatically in

Greece and Portugal, but also in Italy, Spain and to a lesser extent Belgium. Conversely, in Ireland, the tension eased significantly for several weeks, thanks to the sufficiently convincing implementation of the economic adjustment programme. Finally, almost the entire euro area was affected, since countries with the highest rating, such as France, recorded a considerable increase in the spreads in relation to the German Bund.

On 26 October 2011, the European authorities agreed on a range of supplementary measures. In the case of Greece, the aim was to reduce the public debt to 120 % of GDP by 2020. To that end, private investors were invited to set up a voluntary bond exchange with a nominal haircut of 50 % on the notional value of the Greek debt which they held. Euro area Member States would contribute € 30 billion to this operation. It was also decided to provide funding of up to € 100 billion under an adjustment programme running until 2014. Moreover, the firepower of the EFSF was to be augmented by leveraging, either by means of an insurance offered by the EFSF to private investors on the issue of new bonds by a Member State, or via special purpose vehicles in which private and public investors would participate. Agreement was likewise reached on a set of measures to restore confidence in the banking sector, notably by raising the banks' core Tier 1 capital – after valuation of the portfolio of government securities at market price at the end of September 2011 – to 9 % of the risk-weighted assets, and doing so before the end of June 2012. Finally, provisions to improve fiscal coordination and surveillance were announced, notably the adoption in national legislation of the Stability and Growth Pact rules on a balanced budget in structural terms. It was agreed to do more to reinforce economic governance and integration within the euro area. The President of the European Council, in collaboration with the Presidents of the EC and the Eurogroup, will present a report on these questions in March 2012.

At the European Council on 8 and 9 December, the Heads of State or Government of the EU Member States, except the United Kingdom, agreed on a new Fiscal Compact. A rule on the general government

CHART 11 THE SOVEREIGN DEBT CRISIS IN THE EURO AREA



Source : Thomson Reuters Datastream.

structural budget balance, offering an automatic correction mechanism in the event of deviation, will have to be introduced into the national legal systems of the Member States at constitutional or equivalent level. Countries undergoing an excessive deficit procedure will have to submit to the EC and the Council an economic partnership programme detailing the necessary structural reforms to ensure fiscal consolidation. The provisions governing this procedure will be reinforced for euro area Member States, in particular by the more automatic application of sanctions. Furthermore, in order to contain the crisis, the entry into force of the treaty establishing the ESM will be accelerated, and the adequacy of the overall ceiling of the EFSF/ESM, set at € 500 billion, will be reassessed in March 2012. The ESM voting rules will be changed to include an emergency procedure. The provision of additional resources for the IMF in the form of bilateral loans is also envisaged. Finally, in regard to the involvement of the private sector, the unique and exceptional character of the decisions taken on 21 July and on 26 October concerning Greece's debt was clearly spelt out.

During the year under review, concerns over the sustainability of the public debt afflicted the financial sector of the euro area, owing to the substantial portfolios of government bonds held by numerous banks. The worries applied particularly to banks in countries subject to an economic adjustment programme, and to those of other euro area countries where spreads on government bonds in relation to the German Bund had widened considerably. Other banks with relatively sizeable portfolios of those countries' government bonds also felt the effects of this mounting anxiety. Since the euro area's financial sector is closely intertwined, systemic risk increased significantly. Losses on the value of bond portfolios, combined with a slowdown of economic growth, threatened to damage the solvency of a sector already weakened by the financial crisis. Moreover, the depreciation of these securities reduced the value of the collateral available for loans on the interbank market. As explained in more detail in section 2.4, the tensions on the interbank market increased, hampering the funding of banks on that market.

The vulnerability of the financial sector in turn affected the perception of debt sustainability in some countries, particularly those which had already assumed part of the risks of the banking sector. Moreover, in the opinion of financial operators, the level of public debt restricted the capacity of the authorities to provide more support for the banking sector, thus triggering a negative spiral.

Box 1 – Contagion on the government bond markets in the euro area

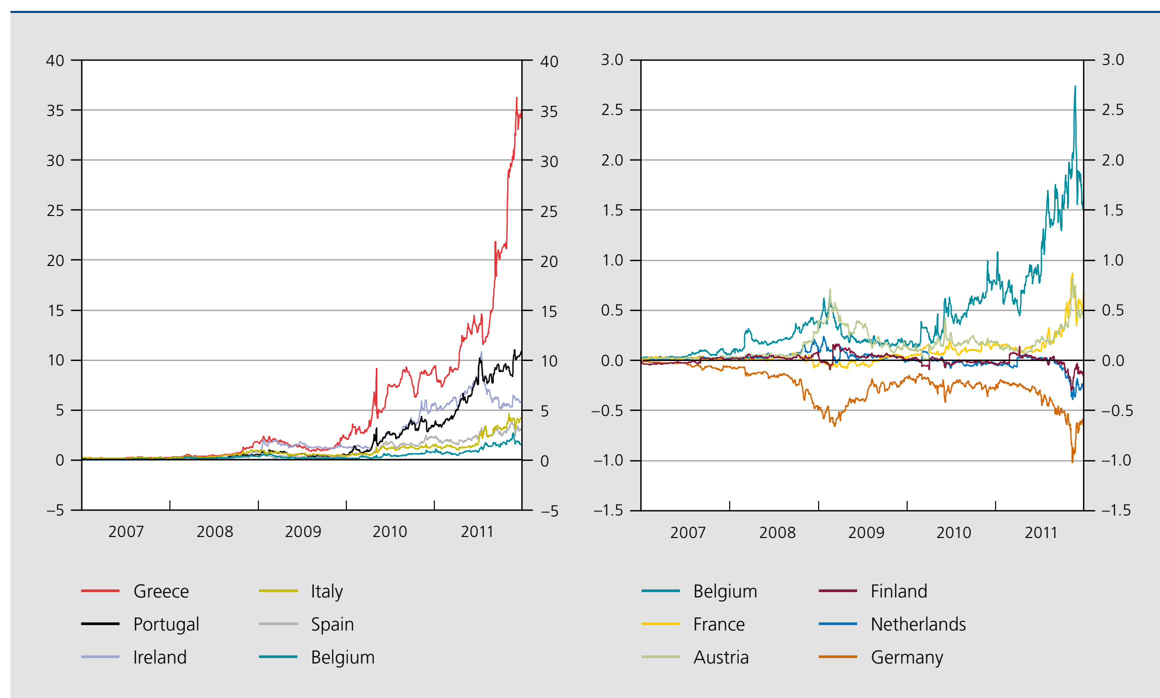
The escalating tensions on a number of euro area government bond markets during the year under review raises questions about the danger of contagion. If rising interest rates in countries with fragile economic fundamentals cause turbulence on the bond markets of other countries, the latter will also face higher financing costs. Moreover, the contagion may imply that shocks on small markets generate a systemic risk for the banking sector. If a drop in government bond prices – and hence an increase in interest rates – in a small country leads to lower bond prices of other States, an initially limited shock may have a much greater impact, notably on the government bond portfolios held by the banks.

The yields on ten-year government bonds on the secondary market discussed in this box can be broken down into two components, one common and the other national. The first reflects the interest rate applicable to debtors with the best credit rating in the euro area, and is based on expectations regarding the monetary policy stance and on a term premium to compensate for the uncertainty inherent in long-term investments. This common component can be approximated by the average ten-year interest rate on bonds issued by five euro area countries with an AAA rating during the period in question – namely Germany, France, the Netherlands, Austria and Finland (1). The second is the risk premium specific to each country, which not only compensates for the default risk, but also comprises a liquidity premium which is inversely related to the ease with which the bonds can be traded.

(1) Luxembourg also has an AAA rating, but there is no ten-year benchmark yield available for the bonds of that State.

NATIONAL COMPONENTS OF THE TEN-YEAR YIELD ON GOVERNMENT BONDS [1]

(percentage points)



Sources: Thomson Reuters Datastream and own calculations.

(1) The difference between the ten-year interest rate of the State in question and the average ten-year interest rate of five euro area Member States with an AAA rating.

For most of the euro area countries, this national risk premium is positive and – since the outbreak of the crisis – has become an increasingly important determinant of ten-year interest rates. In Germany, and to a lesser extent in the Netherlands and Finland, this national component has mostly been negative, bearing witness to the safe-haven status of securities issued by these three countries. That is attributable to the sound economic fundamentals of those countries and, in Germany's case, also to an extremely liquid market in government securities.

Since Germany hence benefits the most from a flight to quality in times of turbulence, caution is required when measuring the national risk premium by means of a very commonly used variable : the spread between ten-year interest rates and the corresponding yields on the German Bund. That yield differential is in fact influenced both by the risk premium of the country concerned and by that of Germany. For the Netherlands, Finland and, to a lesser extent, France and Austria, the flight to quality is indeed the main reason for the spread in relation to Germany.

The contagion between countries can be analysed by a vector autoregressive model in which the variables are the national risk premiums included in the ten-year interest rates. To examine changes in the dynamics of those variables, the model is estimated over moving windows of 100 trading days. A first measure of the contagion, giving an idea of the degree of interaction between the variables, is the correlation between the shocks affecting the national component of the interest rates of different countries. Since the correlation is a yardstick independent of any scale, it does not give any quantitative indication of the extent of the contagion. It is therefore also worth assessing the impact, in basis points per day, which a typical shock in a given country has on the national component of other countries.

This box assesses the contagion originating from two groups of countries under stress. The first comprises three countries with an official EU and IMF financing programme, namely Greece, Ireland and Portugal. The second comprises Spain and Italy. The two measures mentioned above can be used to examine the impact of shocks in those countries on the risk premium of a number of other countries during the period 2007-2011.

MEASURES OF THE CONTAGION BETWEEN GOVERNMENT BOND MARKETS IN THE EURO AREA

(on the basis of a vector autoregressive model estimated using moving windows of 100 trading days, the date referring to the latest observation in the sample considered)

Sources: Thomson Reuters Datastream and own calculations.

(1) Contemporaneous correlation between shocks affecting the national component of countries under stress and those affecting the national component of other countries. Average correlation with Greece, Ireland and Portugal, and with Spain and Italy.

(2) Contemporaneous impact in basis points per day of a typical shock (measured by the standard deviation of the shocks) affecting the national component of countries under stress on the national component of other countries. Average impact of Greece, Ireland and Portugal, and of Spain and Italy.

According to market participants, German sovereign bonds are safe-haven assets. The estimated correlation between the German risk premium and the risk premiums of countries with an adjustment programme, and those of Spain and Italy, was almost always negative during the period considered, indicating that shocks pushing up the risk premium of those countries led to a more negative premium for Germany. The impact of such shocks was generally limited, even though it nevertheless implied a fall of more than one basis point per day during periods of severe turbulence, as in May 2010 or November 2011.

Conversely, the tensions on the bond markets of the three countries with an adjustment programme led to a rise in interest rates in France, although the correlation seems to have weakened during the year under review. Overall, the contagion affecting France seems to have been rather limited, a conclusion borne out by the modest impact on French interest rates of shocks affecting the countries in difficulty. However, during the last quarter of 2011, France apparently did not escape the heightened tension on the Spanish and – especially – the Italian government bond markets.

Compared to France, Belgium has a higher correlation both with the three countries subject to an adjustment programme and with Spain and Italy. Moreover, the impact of the countries in difficulty on the Belgian risk premium was considerably greater than for France. It actually became particularly substantial during the year under review. With an estimated maximum impact of around 5 basis points per day on the Belgian risk premium, the developments in Spain and Italy during the last quarter of 2011 were a significant source of turmoil on the Belgian market. However, their influence waned in December. Over the year as a whole, the typical impact originating from the three countries receiving official financing was around half that originating from Spain and Italy.

Conversely, in periods of worsening turbulence, shocks in countries which had been obliged to resort to loans from the IMF and European partners were responsible to a much greater extent – up to around 6 basis points per day – for interest rate fluctuations in Spain and Italy.

These findings suggest that financial tensions spread from one country to another. During the year under review, the source of that contagion seemed to come increasingly from Spain and Italy, rather than from the countries receiving official financing. While that contagion had a beneficial effect on the financing costs of countries with the soundest economic fundamentals, such as Germany, the opposite applies in other countries such as Belgium, as they in fact face a rise in interest rates in the event of worsening tensions in the most fragile countries. Both the existence and the magnitude of these contagion effects must be properly taken into account when measuring the systemic risk for the banking sector and when preparing scenarios designed to address the turbulence confronting the euro area in 2011.

2.2 Economic activity and labour market

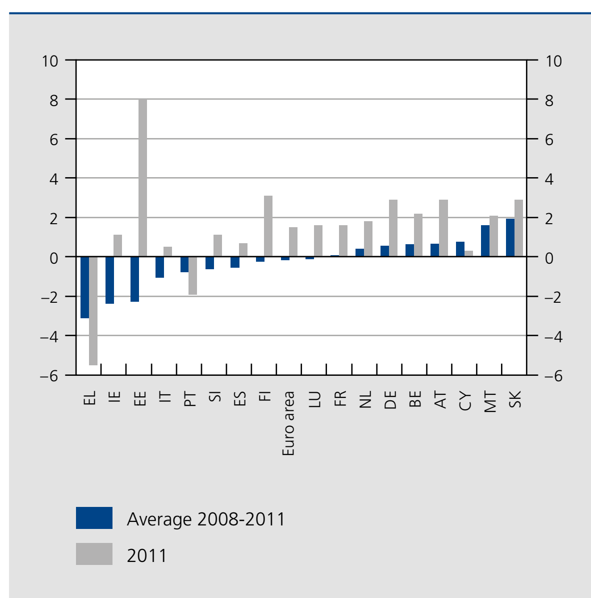
The development of economic activity in the euro area was uneven in 2011. The first quarter was particularly encouraging, confirming the recovery which had begun in 2009. However, economic growth faltered in the second quarter, and then came to a halt. Annual figures as a whole mask that profile: GDP volume growth declined from 1.8 % in 2010 to 1.6 % in 2011. In real terms, GDP has still not regained its 2007 level in the euro area. The stalled return to the pre-crisis level was particularly marked in countries whose growth had previously been based excessively on external borrowing.

The slowdown in the course of 2011 concerned most of the euro area countries. Nonetheless, the year-on-year change in GDP varied widely. Activity contracted in Greece and Portugal, while the strongest growth rates were recorded in Estonia, Finland, Germany, Austria and Slovakia. Broadly speaking, the countries forced by the 2008-2009 crisis to embark on a process of correcting their imbalances continued to record growth rates below the euro area average.

In 2010, the economic recovery had gradually shown signs of broadening across domestic components. At the end of the first quarter of 2011, the vigour of the recovery and this transition process towards self-sustained growth

CHART 12 GDP GROWTH IN THE EURO AREA COUNTRIES (1)

(non calendar adjusted volume data,
percentage changes compared to the previous year)



Source: EC.
(1) The euro area countries are ranked according to average annualised GDP volume growth during the period 2008-2011.

TABLE 2 GDP AND MAIN EXPENDITURE CATEGORIES IN THE EURO AREA (1)

(calendar adjusted volume data,
percentage changes compared to the previous year,
unless otherwise stated)

	2009	2010	2011
Final consumption expenditure of households	–1.1	0.8	0.4
Final consumption expenditure of general government	2.6	0.5	0.0
Gross fixed capital formation	–12.1	–0.6	2.1
Housing	–11.6	–2.9	1.0
Enterprises	–15.6	2.3	4.6
General government	3.9	–6.4	–4.9
Final domestic expenditure	–2.8	0.5	0.6
Change in inventories (2)	–0.8	0.6	0.3
Net exports of goods and services (2)	–0.7	0.8	0.7
Exports of goods and services (3)	–12.8	11.3	6.1
Imports of goods and services (3)	–11.7	9.6	4.8
GDP	–4.2	1.8	1.6

Sources: EC, OECD.
(1) Excluding Cyprus and Malta, except for exports and imports.
(2) Contribution to the change in GDP, percentage points.
(3) Non calendar adjusted data.

seemed to come to a halt. A number of factors curbed that process, such as the erosion of consumer and business confidence and the deterioration in borrowing conditions, taking account of the moderation of global demand and mounting tensions on the markets in sovereign debt securities.

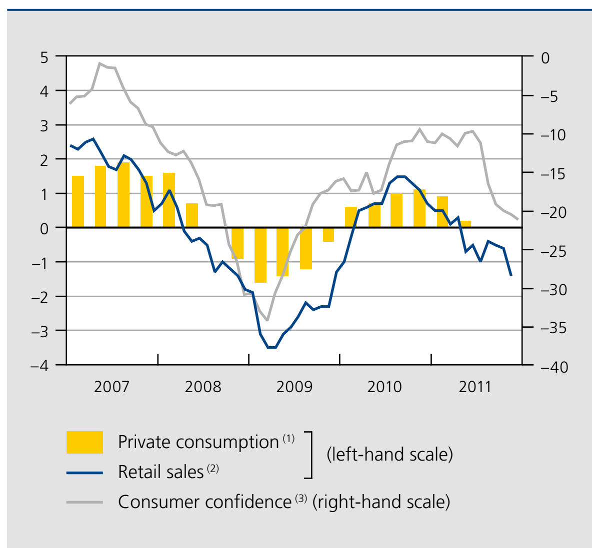
Exports had been the driving force during the initial recovery phase, before domestic demand took over. Export growth weakened from the second quarter of 2011. However, owing to sluggish domestic demand, imports slowed even more, so that net foreign sales took over as the main contributor to growth.

The gradual weakening of the recovery in 2011 was due essentially to dwindling domestic demand. In the first half of the year, inflation surged as a result of higher energy and food prices, outpacing the rise in nominal wages. This depressed consumption from the second quarter. In addition, in the second half of the year, the escalating tensions over the sovereign debt crisis seriously dented consumer confidence. The uncertainty prompted consumers to exercise caution and delay their decisions on the purchase of durable goods. In addition, some specific developments played a role, such as the end of car-scrapping schemes in France, which contributed to the contraction of private consumption in that country during the second quarter.

In addition to this specific context, two more structural factors may also have motivated precautionary savings and may thus have depressed private consumption. First, the considerable debts contracted by households during the years preceding the crisis created a need to restore a better balance between assets and liabilities. Some countries, such as Ireland and Spain, had seen the rapid accumulation of loans to individuals, which had supported domestic demand and fuelled a strong expansion of the housing markets and soaring house prices. Since the 2008 crisis, the need to restore a sound balance sheet forced households to step up their savings. While the debt ratio has already stabilised, or even fallen slightly, in some countries, it seems that debt reduction will be a lengthy process in view of the still high debt levels. A second incentive for individuals to save more was the deterioration in public finances resulting from the crisis.

Gross fixed capital formation had continued to decline during the initial quarters of the recovery which had begun in mid-2009: the revival in business investment had been insufficient to offset the fall in public investment and housing construction. However, the improvement in confidence and higher capacity utilisation encouraged firms to carry out increasing numbers of investment projects, up to the first quarter of 2011, during which gross

CHART 13 PRIVATE CONSUMPTION, CONSUMER CONFIDENCE AND RETAIL SALES IN THE EURO AREA



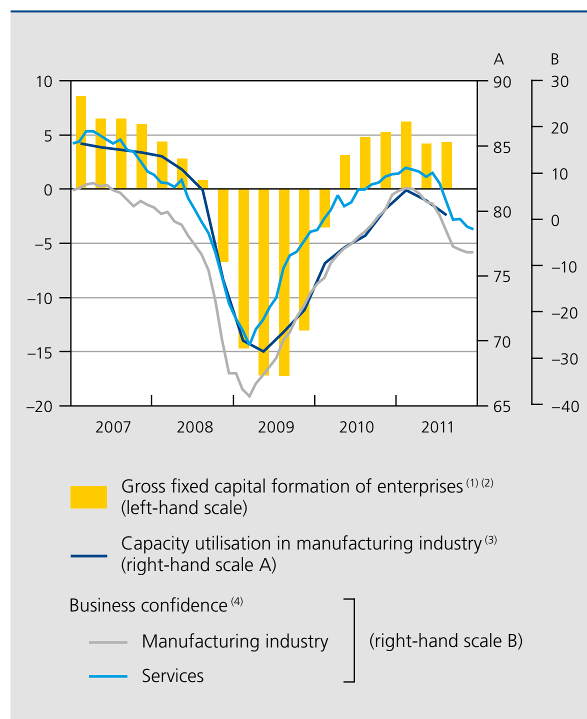
Sources: EC, ECB.
(1) Seasonally and calendar adjusted data, percentage changes compared to the corresponding quarter of the previous year.
(2) Calendar adjusted data, annual percentage changes, three-month moving average.
(3) Seasonally adjusted data, balance of replies to the monthly survey.

fixed capital formation was the main engine of growth. Subsequently, a deceleration occurred in most euro area countries. In some countries, where investment was already declining in 2010, the downward trend continued in 2011, e.g. in Spain, Cyprus, Slovenia, Ireland, Portugal and Greece. Thanks to the strong surge in the first quarter, and starting from a still low level, year-on-year growth of gross fixed capital formation in the euro area came to 2.1 % in 2011. However on the whole, investment remained below its pre-crisis level in real terms.

There are various factors which explain the weakness in business investment growth during 2011. First, in the wake of the slowdown in global trade and the deteriorating economic outlook, firms faced a fall in demand. Capacity utilisation dropped below its long-term average, halting the upward trend. Next, from the summer of 2011, the uncertainty and growing erosion of business confidence contributed to the postponement of investment decisions. As a result, firms' financing needs were reduced, leading to a falling demand for bank loans from the summer. In addition, the escalating sovereign debt crisis led to a tightening of lending conditions, which was particularly pronounced in countries whose fiscal sustainability was most in doubt. Finally, the deleveraging process which many companies have embarked on since the crisis may also have prompted some of them to moderate their investment spending.

The construction sector had been the epicentre of the recession in some countries. In the euro area as a whole, investment in housing began rising again in 2011, after three years of decline. This occurred against the backdrop of a recovery on the property market, as house prices – which had fallen to a low point in mid-2009 – continued to rise slightly in the first half of 2011. In addition, bank lending for house purchase expanded, though less strongly from the spring onwards, partly because of the tighter credit conditions. While remaining at levels which were still relatively low, mortgage interest rates on new contracts gradually rose before easing slightly from September. However, the developments in the construction and property sector of the euro area as a whole mask still very contrasting situations between countries. In 2011, investment in housing declined in Greece, Cyprus, Slovenia, Spain and – above all – Ireland, while it remained relatively dynamic e.g. in Germany, where the construction sector enjoyed a strong boost in the first quarter, the indirect consequence of the exceptional weather conditions at the end of 2010.

CHART 14 BUSINESS INVESTMENT AND BUSINESS CONFIDENCE IN THE EURO AREA
(seasonally adjusted data)



Sources: EC, OECD.
(1) Data also calendar adjusted, percentage volume changes compared to the corresponding quarter of the previous year.
(2) Excluding Cyprus and Malta.
(3) Measured by the quarterly survey, in %.
(4) Balance of replies to the monthly survey.

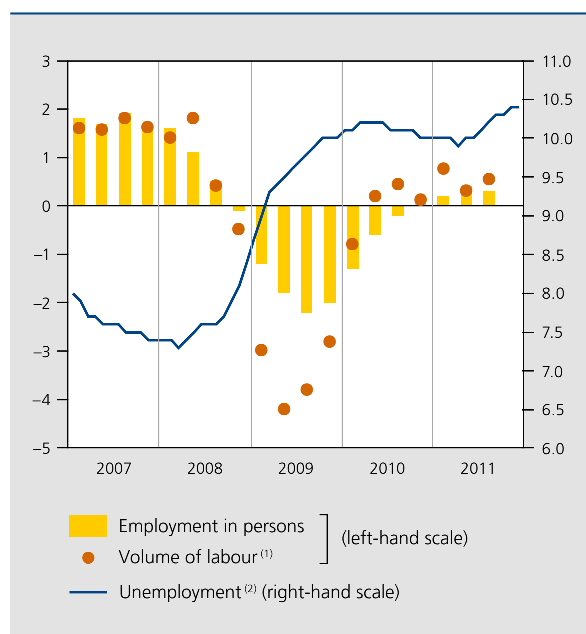
On the labour market, the situation in 2011 was still influenced by the labour-hoarding efforts that businesses had made during the recession, which had been supported by various government measures for reducing working time. Given the relative resilience of the labour market in 2009, its recovery was very moderate up to the beginning of 2011. Firms tended to restore normal working hours per worker rather than create jobs in order to adjust the volume of labour to the pick-up in activity. In the second quarter of 2011, this upward trend in the hours worked began to level out, while employment growth in terms of the number of persons became stronger. In 2011, employment was stimulated *inter alia* by property and rental services, and business services (excluding financial and insurance activities), but also by industry (excluding construction), where the number of jobs increased slightly. The construction sector, still in an adjustment phase, continued to record job losses. From the second half of 2011, the improvement in the labour market faded away as economic activity lost momentum. The unemployment rate had stabilised at around 10 % since 2010. Nonetheless, during the year under review it edged upwards very gradually after the April low point to reach 10.4 % in December.

The disparities between labour markets in the euro area countries remained considerable in 2011. Employment growth was still above average in Estonia, Luxembourg, Slovakia, Austria, Germany, Belgium and Finland. Conversely, Ireland, Portugal, Spain and Slovenia continued to shed jobs, albeit to a lesser extent than in 2010, and job losses worsened in Cyprus and – above all – Greece. This heterogeneity was also evident in the unemployment rates which ranged between 4.1 % in Austria and 22.9 % in Spain at the end of 2011.

The labour market diversity reflects a number of factors. First, the euro area debt crisis had a widely varying impact on the financial sector and fiscal policy scope, depending on the country. Also, the sectoral composition of the job losses caused by the 2008-2009 crisis still had a major influence : a process of restructuring production and rebalancing between sectors of activity continued in 2011 in some countries, such as Spain and Ireland, where the adjustment following the bursting of the property bubble was incomplete. Finally, the institutional settings and regulations specific to each country also played a role. Thus, employment growth was found most dynamic in 2011 in Germany, where the effects of the earlier Hartz reforms fostered employment by getting the jobless back to work. In contrast, in Spain the persistence of a dual employment contract situation perpetuated the lack of flexibility on the labour market.

CHART 15 LABOUR MARKET IN THE EURO AREA

(percentage changes compared to the corresponding quarter of the previous year, unless otherwise stated)



Sources : EC, ECB.
(1) Total hours worked.
(2) Ratio in % between the number of unemployed persons and the labour force.

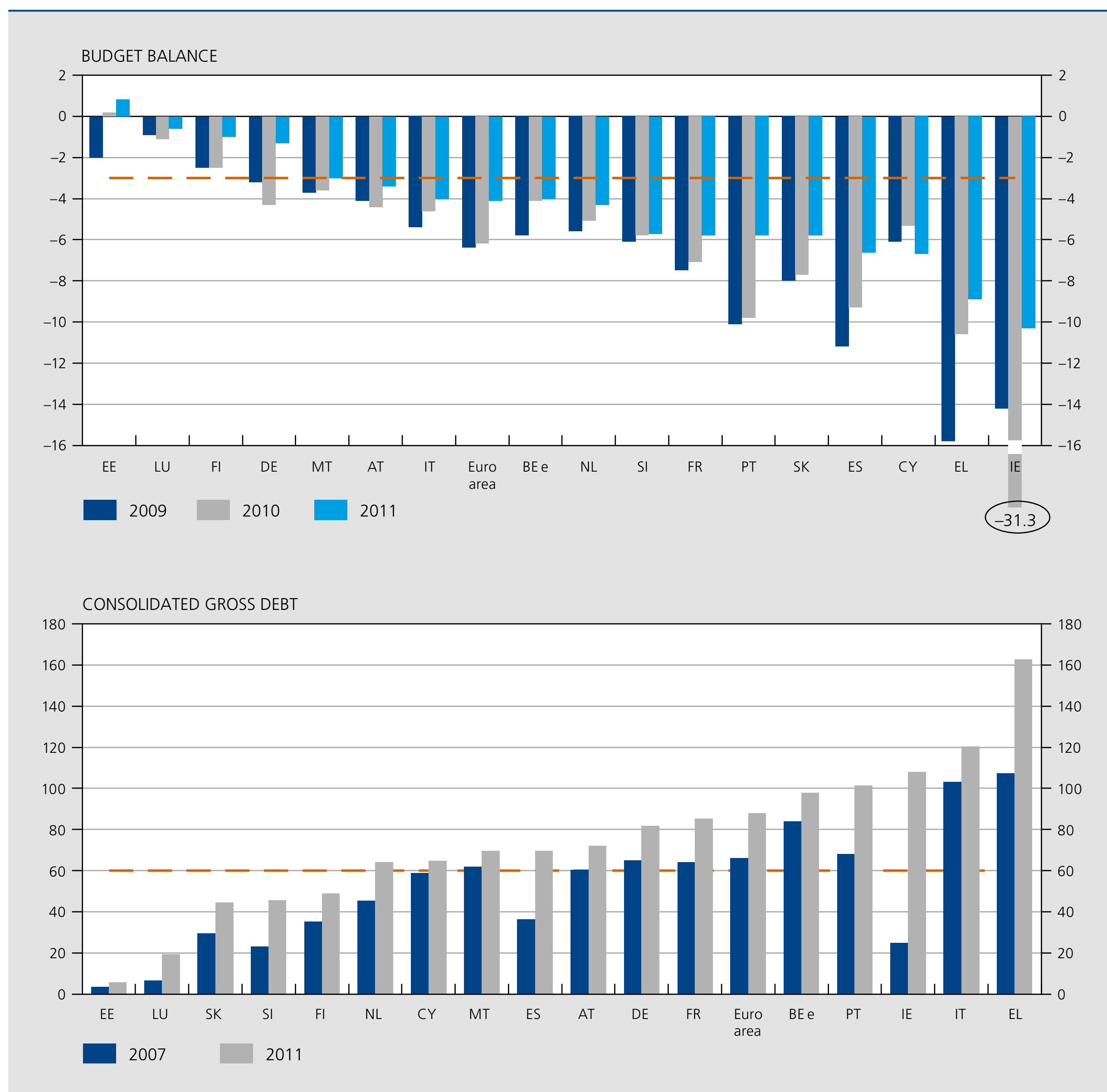
2.3 Fiscal policy

The economic recovery which persisted in the first half of the year contributed to the cyclical strengthening of the general government budget balance in the euro area, whereas in the second half of the year the deterioration in the general economic situation and mounting tensions on the debt securities markets of several countries made it necessary to speed up the pace of structural fiscal consolidation in most of the euro area countries. The reduction in the deficit which – according to the EC's November 2011 economic forecasts – dropped from 6.2 % of GDP in 2010 to 4.1 % in 2011 is attributable partly to cyclical and temporary factors, but is due mainly to the measures taken to cut the structural deficits. The general government debt ratio continued to rise in 2011, with a cumulative increase of almost 22 percentage points of GDP since 2007. However, its growth pace was slower than in the preceding three years, rising by only 2.4 percentage points to 88 % of GDP. This deceleration is due mainly to the perceptible improvement in the primary budget balance and the disappearance, at aggregate level, of the net interventions supporting the banking sector.

Only four euro area countries recorded a general government deficit of less than 3 % of GDP in 2011 : Estonia,

CHART 16 GENERAL GOVERNMENT BUDGET BALANCE AND DEBT IN THE EURO AREA [1]

(in % of GDP)



Sources: EC, NBB.
(1) The countries are ranked according to 2011 data.

Luxembourg, Finland and Germany. The deficit of the first three already stood below that threshold in 2010. In **Germany**, the budget deficit dropped from 4.3 % of GDP in 2010 to 1.3 % in 2011. That country thus corrected its excessive deficit two years before the end of the specified term. This recovery was due to the favourable cyclical conditions, the phasing-out of the non-recurring measures which had raised the deficit in 2010, and structural consolidation achieved by health care system reforms and the implementation of an austerity plan. This plan entailed in particular the introduction of new taxes on aviation, nuclear energy and banks, and a reduction in family allowances and benefits for the long-term unemployed.

Still according to the EC's November 2011 economic forecasts, all other euro area countries except Cyprus also cut their public deficit in 2011, though it still exceeded or equalled 3 % of GDP. In **France**, the general government deficit declined from 7.1 % of GDP in 2010 to 5.8 % in 2011. Apart from the phasing-out of the cyclical stimulus measures, this improvement is essentially structural and is due mainly to the reduction of "tax niches", i.e. tax

exemptions and reductions, and various measures affecting expenditure, such as the freeze on base wages for civil servants and the replacement of only half of retiring civil servants. In **Italy**, despite the rise in interest expenditure of around 0.4 percentage point of GDP in 2011, the growth of the primary surplus allowed for a cut in the budget deficit by 0.6 percentage point to 4 % of GDP. This largely structural improvement is due to the reduction in primary expenditure as a share of GDP, achieved partly by freezing civil servants' wages and by public employment cuts. Public debt continued to rise, from 118.4 % of GDP at the end of 2010 to 120.5 % at the end of 2011. In December, a set of additional measures was announced equivalent to 1.3 % of GDP, aimed at achieving a balanced budget in 2013. In **Spain**, numerous measures were taken from mid-2010 onwards in order to cut expenditure, notably by freezing public sector wages and reducing public investment, and to boost revenues by increasing both direct and indirect taxation and introducing a wealth tax. According to the IMF's January 2012 forecasts, the general government deficit declined by 1.3 percentage points of GDP to 8 % of GDP, nevertheless well above the 6 % target. In December, the new government announced a package of measures amounting to 1.5 % of GDP.

The countries receiving conditional financial assistance from the EU and the IMF made significant efforts to consolidate their public finances. However, in **Greece**, owing mainly to a further worsening of the economic contraction, the public deficit was reduced by only 1.6 percentage points in 2011 to 9 % of GDP, according to the report prepared by the IMF concerning the fifth assessment of the adjustment programme accompanying the EU and IMF emergency aid granted in May 2010. In view of the slump in economic activity, the public debt reached an estimated 162 % of GDP at the end of 2011, an increase of 17 percentage points in one year. Significant measures were taken to restore the viability of public finances, notably in terms of cutting government spending. However, though the Greek authorities had managed to reduce the deficit considerably in 2010, the success of the programme was thwarted by numerous setbacks in 2011. Owing to delays in implementing the reforms and the decline in activity, the fiscal target was again exceeded. In order to achieve the objectives in 2012, supplementary consolidation measures were taken from the summer of the year under review.

In **Ireland**, the general government deficit had risen sharply in 2010, owing to expenditure on the government rescue package for the banks amounting to 20 percentage points of GDP. In the autumn of 2010, the Irish authorities requested financial aid from the EU and the IMF, and embarked on a large-scale economic adjustment programme aimed primarily at cutting the general government deficit below 3 % of GDP by 2015 and restoring a sound banking system. A year later, the quarterly assessment of this programme concluded that it had been implemented satisfactorily. The budget deficit is estimated to have fallen just below the target of 10.6 % of GDP in 2011. In its autumn economic forecasts, the EC estimated the public debt at 108.1 % of GDP at the end of 2011, up by 13.2 percentage points against the end of 2010.

Like Greece and Ireland, though somewhat later, **Portugal** received financial aid from the EU and the IMF in May 2011. The economic adjustment programme adopted as a condition for that aid comprises a major fiscal consolidation component aiming to put the public debt ratio on a downward path in the medium term and cut the deficit below 3 % of GDP in 2013. The government is estimated to have met the target of a deficit amounting to 5.9 % of GDP in 2011, almost 4 percentage points lower than the previous year, by means of substantial structural measures concerning both expenditure and revenue, and a one-off budget operation concerning bank pension funds. According to the autumn review of the Portuguese economic programme, the public debt continued to grow, rising from 93.3 to 107.2 % of GDP in 2011.

2.4 Monetary policy of the Eurosystem

Macroeconomic prospects in the euro area were decidedly contrasted in the year under review, and that was reflected in the decisions of the ECB Governing Council. At the beginning of the year, economic activity continued to pick up, fuelling some optimism about future growth. At the same time, inflationary pressures gradually increased, propelled by the rising cost of energy and other commodities. To tackle the upside risks to price stability against the backdrop of a revival in activity, the Governing Council raised the key interest rates twice. After having been held at the historically low level of 1 % for almost two years, the central key interest rate was thus increased in stages to 1.25 % on 7 April and 1.50 % on 7 July. Conversely, in view of the persistent malfunctioning in certain segments of the euro area's financial markets in the context of the sovereign debt crisis, the Governing Council retained the non-conventional monetary policy measures which were in place at the end of 2010.

During the summer, renewed concern about Greece's financial situation led to escalating tensions on a number of sovereign debt securities markets. To calm the resulting turbulence on the interbank market and rectify the disruption in the monetary policy transmission, the Governing Council took new non-conventional measures.

At the beginning of August, it thus decided to conduct a six-month refinancing operation and to reactivate the Securities Markets Programme (SMP). On 6 October, it announced the conduct of one-year refinancing operations and the launch of a new programme for the purchase of covered bonds, i.e. bonds backed by a range of mortgage loans or claims on the government. In addition, in view of the sharp deterioration in the confidence of economic agents and in financing conditions, growth expectations were downgraded considerably. In these circumstances, the Governing Council cut the ECB's central key rate to 1.25 % on 3 November, and then to 1 % on 8 December. Despite a persistently high level of inflation, it considered that the financial tensions presented a significant risk to growth, and that – in view of the slackening pace of activity – the inflationary pressures would gradually ebb away. Inflation would therefore remain at a level compatible with the objective of medium-term price stability. In December, in order to continue to support bank liquidity and encourage bank lending in the euro area, the Governing Council also adopted a new series of non-conventional measures. It decided to conduct two refinancing operations with a maturity of 36 months, to expand the range of assets eligible as collateral for Eurosystem loans and to cut the minimum reserve ratio from 2 to 1 %.

The monetary policy stance

During the **first half of 2011**, the monetary policy stance was dictated mainly by the mounting inflationary pressures. Maintaining a trend which had begun in mid-2009 and was confirmed during 2010, euro area economic activity gathered pace at the start of the year under review, and the outlook remained favourable. In April, the capacity utilisation rate thus increased to just above its long-term average. In view of the publication of better-than-expected economic data and the particularly strong GDP growth in the first quarter, the growth projections for the year were revised upwards in the macroeconomic projection exercises of the ECB and the Eurosystem in March and June. That was also the case for the forecasts produced by other international institutions and professional forecasters. It was expected that private domestic demand, stimulated by an accommodating monetary policy stance and by measures to support the financial system, would make an increasing contribution to growth, and that exports would continue to benefit from the global economic recovery. However, the revival in economic activity would be curbed to some extent by the ongoing balance sheet adjustment process in various sectors. Despite the persistence of great uncertainty as a result of the sovereign debt crisis and tensions in certain financial market segments, the scenario of a continuing – still modest – recovery prevailed, and the risks to that outlook were generally considered to be balanced.

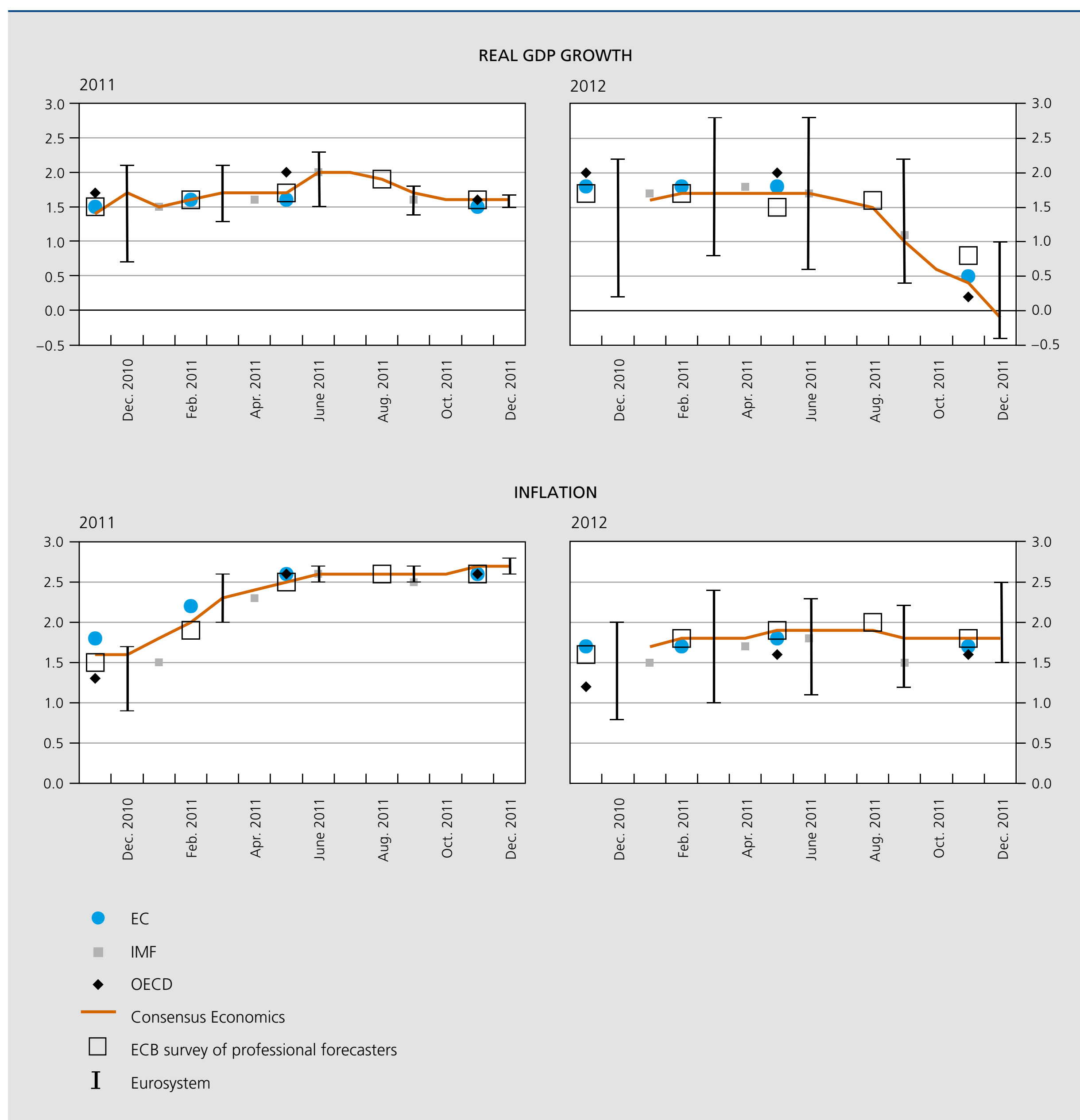
This positive dynamic was accompanied by a rapid rise in inflation measured by the HICP, which had been running at more than 2 % from the start of the year. That acceleration mainly reflected the rising cost of energy and other commodities, due in particular to the strong economic growth in the emerging countries and the political tensions in North Africa and the Middle East. In that context, there were soon upside risks to price stability, and they were amplified as the months went by. Underlying inflation – namely the movement in consumer prices excluding energy and food – also displayed an upward trend, confirming the increase in inflationary pressures in the euro area. Between December 2010 and June 2011, it rose from 1 to 1.6 %.

In line with the encouraging outlook for GDP growth, bank lending to the private sector and money creation continued to expand in the first months of the year. Overall, however, the expansion was modest and there were significant variations between economic agents. Thus, the growth of lending to households remained stable overall, in the region of 3 %, while there was a very marked upward trend in the growth of lending to non-financial corporations. After having returned to positive figures in October 2010, the latter gradually increased to 2.3 % in June 2011. This catch-up effect was largely anticipated. According to the normal profile over the business cycle, the expansion of business lending follows the revival in economic activity after a certain time lag, while the growth of lending to households tends to precede it. This difference of timing is attributable partly to the fact that loans for house purchase enjoy better collateral, while firms generally resort to self-financing in the initial stages of the recovery.

Leaving aside its volatility, due mainly to the impact of specific factors, the monetary dynamism strengthened during the first months of the year while continuing to be restrained to some extent by the steepness of the yield curve, which reduced the attraction of monetary assets as opposed to longer-term instruments offering better returns, which are not included in M3. In addition, the monetary liquidity previously accumulated remained abundant, so that – in a favourable economic climate – there was a risk of growing pressures on prices in the euro area and hence an impact on medium-term price stability. Regarding the components of M3, the year-on-year growth of M1 declined while that of short-term deposits included in M2-M1 increased considerably. This partly reflected the rise in the remuneration of savings deposits and other short-term deposits during

CHART 17 PROJECTIONS OF REAL GDP GROWTH AND INFLATION IN THE EURO AREA

(annual percentage changes according to the projection publication dates)



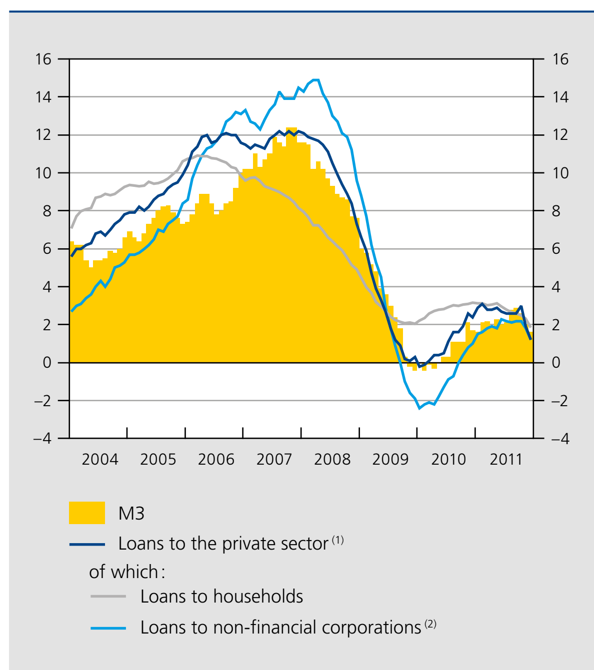
Sources: EC, IMF, OECD, Consensus Economics, ECB.

the initial months of the year. In the case of marketable instruments, namely M3-M2, the year-on-year change was very volatile, largely as a result of the impact of collateralised interbank transactions conducted via central counterparties – which perform the role of intermediaries for the transactions. Since those counterparties belong to the money-holding sector, the transactions they conduct for the banks appear temporarily in the broad monetary aggregate M3, but without representing a real increase in the money supply.

In this context featuring a favourable trend in activity – despite a still high level of uncertainty – and the accentuation of the upside risks to price stability, the Governing Council considered it appropriate, at its meetings on 7 April and 7 July, to raise the key interest rates by 25 basis points, thus bringing the central key rate to 1.50 %. After having held the rates at historically low levels for almost two years, it considered that these adjustments to the highly accommodative monetary policy stance were needed in order to prevent the emergence of

CHART 18 M3 AND LOANS TO THE PRIVATE SECTOR IN THE EURO AREA

(percentage changes compared to the corresponding month of the previous year, seasonally adjusted data)



Source: ECB.
(1) Households, non-financial corporations, insurance companies, pension funds or occupational pension institutions and other non-monetary financial intermediaries. Data adjusted for sales and securitisation, unless otherwise stated.
(2) Data not adjusted for sales and securitisation before February 2010.

second-round inflationary effects threatening the objective of maintaining inflation in the medium term at levels close to but below 2 %.

It should be noted that the macroeconomic outlook described above for the euro area as a whole masks disparities between its constituent countries. Thus, in the first six months, the core countries surrounding Germany generally recorded higher growth rates than the southern euro area economies, leading to differences in inflationary pressures. The Governing Council cannot take account of this heterogeneity in the macroeconomic developments of euro area countries when taking decisions on the key interest rates, as the latter have to reflect the economic outlook and risks to price stability in the euro area as a whole. However, some national developments may influence the implementation of other monetary policy instruments, such as the non-conventional measures discussed at the end of this chapter.

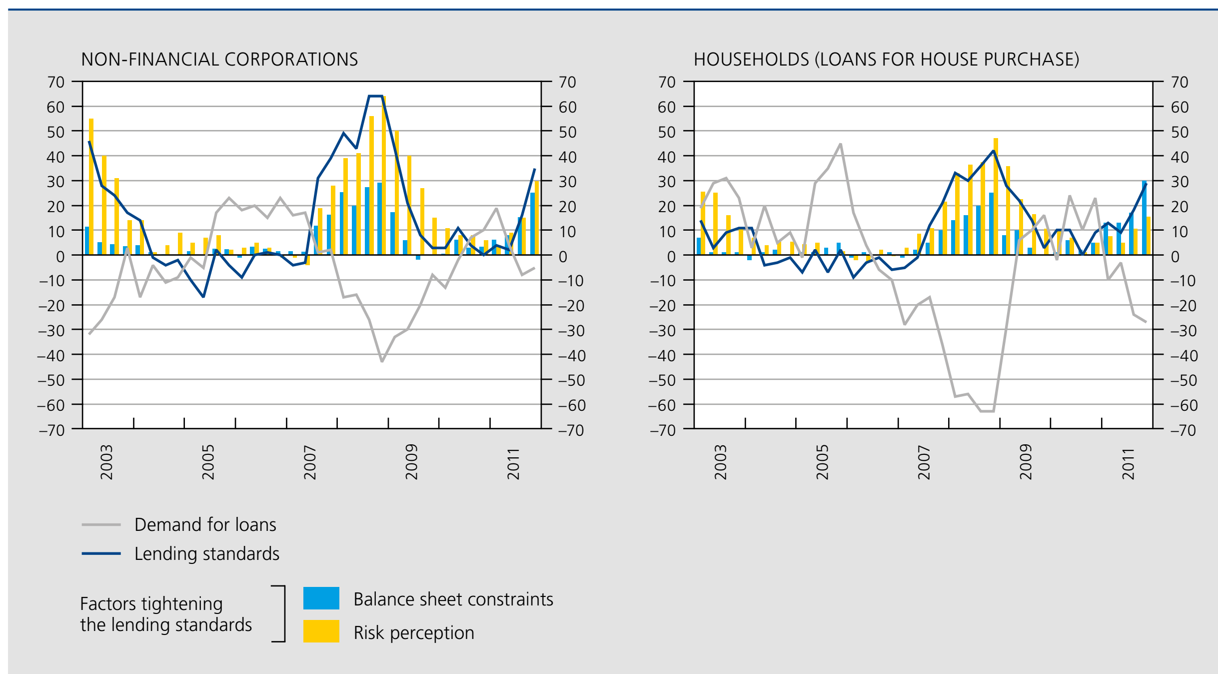
In the **second half of 2011**, the Governing Council adjusted the monetary policy stance following the deterioration in the growth prospects and the easing of inflationary pressures. July was the turning point in the economic and financial situation of the euro area. Although a temporary dip in activity was expected, the figures steadily worsened, casting doubt on the vigour of the recovery. The temporary factors which had stimulated growth at the start of the year, such as the significant upturn in construction activity and certain fiscal stimuli, had in fact disappeared while the negative impact of the delayed effects of the earlier oil price increases and a marked slowing of the expansion of world trade became apparent. The mounting concern over the trend in economic activity was also amplified by the fiscal consolidation measures adopted in various countries, and by the spreading unease caused by the sovereign debt crisis. The focus of the fears shifted from Greece, Ireland and Portugal to Spain and Italy, where sovereign bond yields rocketed during the summer. In this climate of escalating tensions on various financial market segments and particularly high levels of uncertainty, financing conditions were tightened and the confidence of the economic agents, which had remained high up to then from a historical perspective, rapidly diminished. By September, this situation combined with a decline in the global growth rate led to a marked downward revision of the euro area GDP projections for 2011, and especially for 2012. Moreover, the Governing Council considered that there were downside risks to these projections.

Despite a slowdown in activity, inflation measured by the HICP continued to rise at first, reaching 3 % in September. However, it had been widely expected to level out in the autumn, before subsiding and reverting to a level fully compatible with price stability in 2012, following the dissipation of the effects of the previous commodity price increases. Against the backdrop of weakening growth, the risks to price stability seemed more balanced. In addition, the pace of monetary expansion remained modest in the second half of the year, and even slowed significantly at the end of the year. As is evident from the results of the euro area bank lending survey, the lending standards were tightened, reflecting both the tougher balance sheet constraints and the increased risk perception. This tightening combined with falling demand depressed the expansion of bank lending to households and businesses. The growth of the aggregate M3 largely reflected the pattern of interbank transactions conducted via central counterparties. It accelerated during the summer, when banks made more use of the secured market against the backdrop of escalating financial tensions, but slackened at the end of the year, probably owing to the new non-conventional measures adopted by the ECB Governing Council. Finally, the accelerating expansion of the aggregate M1 from August may well have reflected the desire to hold more liquidity in times of growing uncertainty.

In view of the signs of a sharper-than-expected slowdown in economic activity in the euro area, and despite a still

CHART 19 EUROSYSTEM SURVEY OF BANK LENDING IN THE EURO AREA [1]

(quarterly data)



Source: ECB.

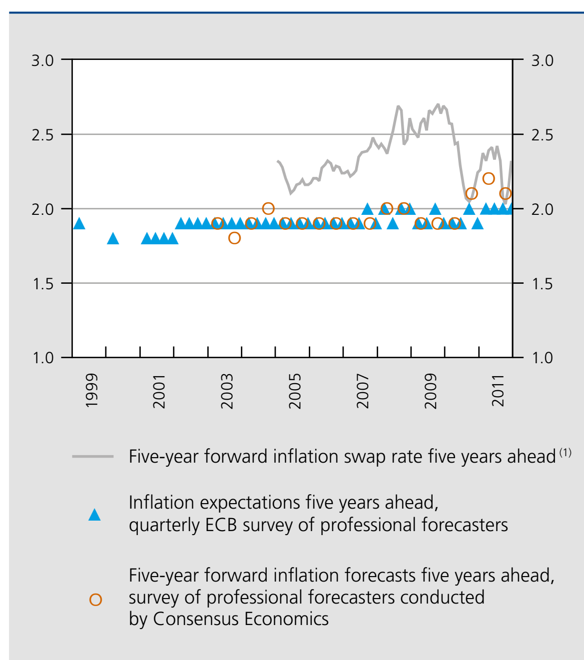
(1) Net percentages of replies from banks to the Eurosystem's bank lending survey indicating the degree of tightening or easing (–) of lending standards and the positive or negative (–) movement in demand for loans.

high level of inflation, at its meetings on 3 November and 8 December the Governing Council deemed it appropriate to cut the key interest rates by 25 basis points on both occasions. It in fact considered that the moderation of global growth and the adverse impact of the financial market tensions on borrowing conditions and confidence represented a threat to economic growth in the euro area. In these circumstances, it considered that the inflationary pressures would wane more rapidly than expected, and that a cut in the key interest rates would help to maintain medium-term price stability.

Despite the relatively high level of inflation throughout the year, long-term inflation expectations based on survey data and financial data remained firmly anchored. The inflation expectations indicated by surveys of professional forecasters conducted by the ECB and by Consensus Economics thus remained stable at around 2 %. The expectations of the financial markets were rising in the first half of the year, but declined in the second half, dropping to a level closer to 2 %. These measures based on inflation swaps are more volatile, and generally exceed those derived from surveys since, in addition to actual inflation forecasts, they include risk premiums which fluctuate over time and blur the signal regarding expectations, especially in a climate of financial tensions.

CHART 20 LONG-TERM INFLATION EXPECTATIONS IN THE EURO AREA

(annual percentage changes)



Sources: Bloomberg, Consensus Economics, ECB, NBB.

(1) Implicit inflation rate derived from swaps covering the inflation risk in the euro area, for a period of five years beginning five years after the conclusion of the contract.

Measures to safeguard the transmission of monetary policy

Despite encouraging economic developments, the uncertainty caused by the sovereign debt crisis remained considerable throughout the **first half of the year**. Therefore, together with its decisions to raise the key interest rates, the Governing Council maintained a number of measures which it had adopted during the period of severe financial market tensions in the autumn of 2008 and the spring of 2010. It judged that those measures remained necessary to safeguard financial stability and the efficient transmission of monetary policy, conditions essential for maintaining price stability. This distinction between conventional measures, namely the steering of the key interest rates, and non-conventional measures for granting liquidity and purchasing securities, conforms to the "principle of separation" between the monetary policy stance and its implementation. That principle, which guides the Governing Council's decision-making process, is a significant feature of the flexible monetary policy framework available to the Eurosystem.

The first of the non-conventional measures maintained is the conduct of Eurosystem refinancing operations in the form of fixed-rate tenders with full allotment. For the main refinancing operations – which take place weekly – and exceptional operations for a term coinciding with the reserve maintenance period – of around one month – the interest rate applied is the central key rate in force at the time of the tender. For longer-term operations, it corresponds to the average rate of the main refinancing operations conducted throughout the duration of the operation in question. Contrary to normal practice, whereby refinancing operations take the form of competitive tenders, this procedure enables the banks to be sure of obtaining all the requested liquidity. It thus reduces their liquidity constraints when there is a loss of confidence on the interbank market, and maintains a supply of credit for households and businesses at affordable interest rates. This measure had been adopted in October 2008, under the "enhanced credit support" policy which had been introduced following the escalating financial tensions caused by the failure of Lehman Brothers. It had been suspended temporarily for regular three-month operations at the start of 2010, but reintroduced in May of that year in the wake of the first wave of tensions caused by the sovereign debt crisis.

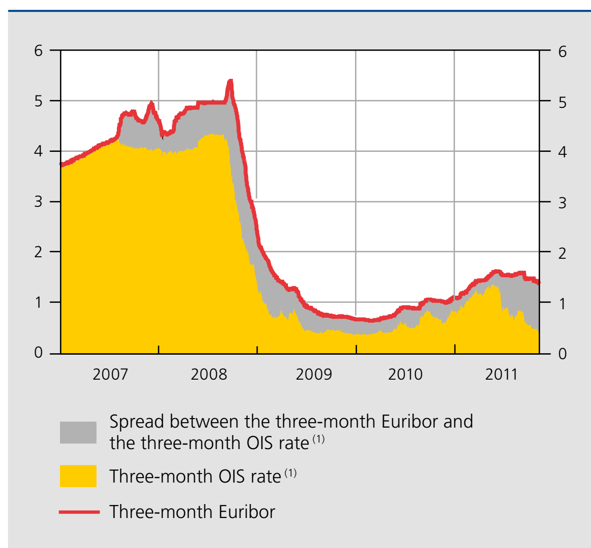
The second measure retained is the Securities Markets Programme (SMP), introduced in May 2010 in the context of the sovereign debt crisis. With this programme, the Eurosystem aims primarily – by purchasing public debt securities on the secondary market – to restore the smooth functioning of the securities markets, thereby preserving the monetary policy transmission mechanism. Government securities are traditionally a key element in the transmission process, as their interest rates are used as benchmarks for setting rates on other financial contracts and for remunerating fixed-income securities. Moreover, they are regularly used as collateral for interbank contracts. Consequently, any excessive or abrupt fluctuation in the value or availability of these securities may lead to a deterioration in funding conditions for banks and have negative repercussions on the supply and price of bank lending to households and businesses. The impact of the SMP on banking sector liquidity is systematically sterilised by weekly liquidity-absorbing operations.

One of the other measures taken previously and still in force in 2011 is the extension of the list of eligible collateral for the refinancing operations. However, the Governing Council had decided, in 2010, to apply a progressive haircut, from 1 January 2011, to the assets with the lowest rating. The swap agreements with the Federal Reserve were also maintained, enabling the Eurosystem to provide liquidity in US dollars against the provision of eligible collateral. Finally, the suspension of the minimum rating requirements for bonds issued or guaranteed by the Greek government was not amended. On the contrary, in order to ensure that banks from other countries in serious difficulties had access to Eurosystem liquidity, the Governing Council adopted similar provisions for securities issued or guaranteed by the Irish government, on 31 March, and the Portuguese government on 7 July.

In the **second half of the year**, as the financial tensions became more acute, the Governing Council adopted new measures. On the basis of the renewed concerns over Greece's ability to repay its debt, mounting tensions became apparent during the summer on a number of public debt markets in the euro area. While spreads in relation to the German Bund widened again for all sovereign bonds, Italy and Spain were particularly affected, marking a further stage in the contagion of the sovereign debt crisis. These events were accompanied by a general increase in aversion to risky assets and a marked deterioration in the situation on the interbank market.

On the money market, risk premiums began rising again. While the difference between the Euribor and the three-month OIS rate remained well below 50 basis points during the first half of the year, it climbed steadily to almost 100 basis points by early December, a level not seen since the beginning of 2009 in the early stages of the financial crisis. However, this increase in the risk premium was more than offset by a decline in

CHART 21 THREE-MONTH INTEREST RATES
(daily data)

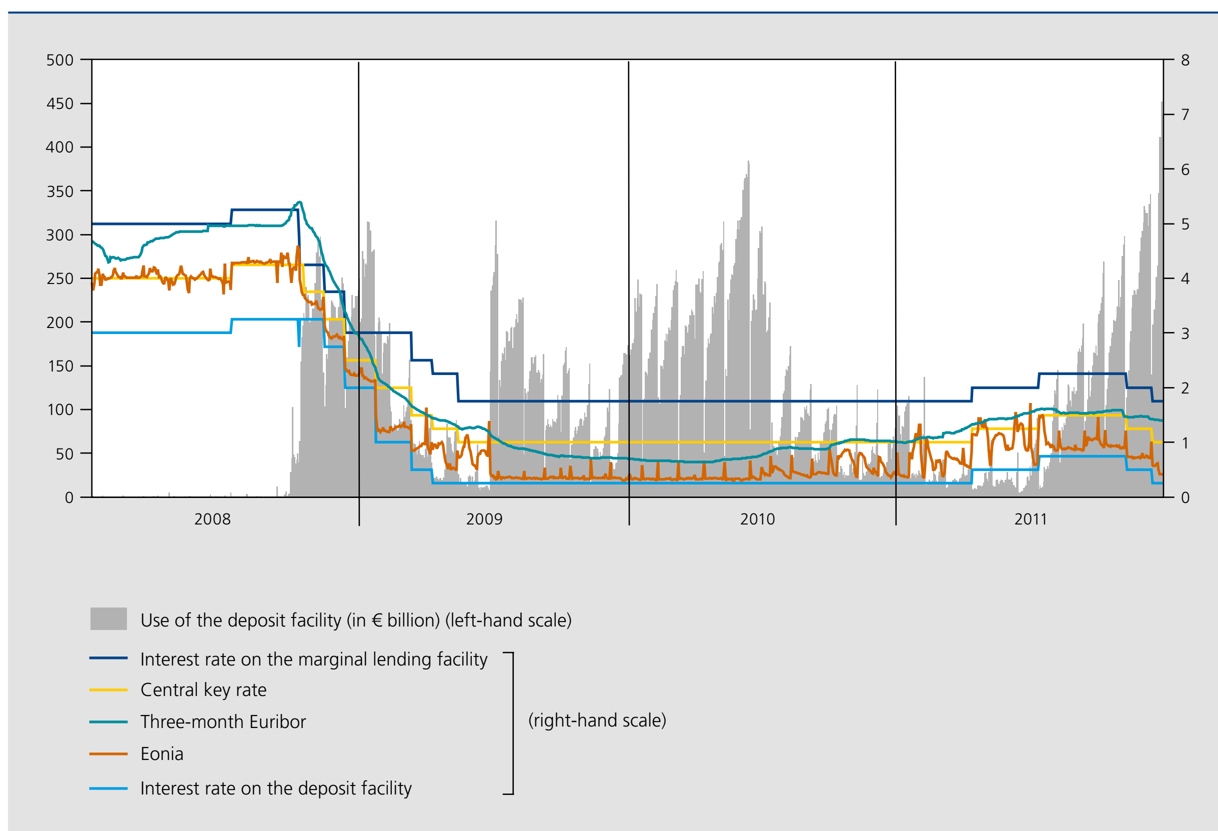


Sources: ECB, Thomson Reuters Datastream.
(1) Overnight Index Swap rate: the fixed rate paid by the counterparty of an interest rate swap contract receiving the overnight interest rate (Eonia) for a period of three months.

the OIS rate, reflecting a downward revision to expectations regarding the key interest rates in the context of slackening economic activity. The three-month Euribor, the benchmark for setting rates on private sector loans, thus remained relatively stable, edging downwards in the wake of the November and December cuts in the key interest rates.

Credit institutions' reluctance to lend to one another was also reflected in greater recourse to Eurosystem loans from August onwards. As a result, the liquidity surplus on the money market increased considerably from an average of € 30 billion in the first six months of the year to almost € 150 billion in September, and over € 300 billion in December. In this connection, it is important to note that the greater use of the deposit facility is the almost automatic corollary to wider recourse to Eurosystem refinancing operations. The liquidity injected in this way can only have a very partial and delayed effect in boosting demand for banknotes or increasing reserve requirements, the main potential "leaks" in the closed circuit of central bank money in the banking system. The increase in

CHART 22 USE OF THE DEPOSIT FACILITY AND MONEY MARKET INTEREST RATES IN THE EURO AREA
(daily data)



Sources: Thomson Reuters Datastream, ECB.

deposits placed with the Eurosystem therefore illustrates the tensions on the interbank market but says little about the movement in bank lending and banks' portfolios of securities.

In parallel with this increase in liquidity, the overnight interest rate on the interbank market (Eonia), which had been volatile up to mid-July, repeatedly exceeding the central key interest rate, reverted more systematically to a level close to the deposit facility rate. The movement in the Eonia follows a fairly simple logic, linked both to the Eurosystem's policy of granting unlimited liquidity and to the level of confidence on the unsecured interbank market. At times of high tension on the latter, only a handful of banks – the soundest ones – have access to it, and the Eonia tends to approach the deposit facility rate, its natural floor. The other banks which are short of liquidity have to borrow more from the Eurosystem in order to refinance themselves on acceptable terms, while the banks with a liquidity surplus place it with the Eurosystem at the deposit facility interest rate. Conversely, when confidence improves, some banks gradually find their way back into the unsecured market at interest rates lower than that on the ECB's main refinancing operations. The resulting discrimination between borrowers on the interbank market drives the Eonia higher.

The tensions triggered by the sovereign debt crisis on the interbank market prompted the banks to tighten their lending standards, thereby threatening the effective transmission of monetary policy. In that context, and in order to ease the banks' funding constraints, the Governing Council phased in new non-conventional monetary policy measures from August onwards. It first decided to conduct a new six-month liquidity-providing operation at a fixed interest rate and with full allotment, in which the interest rate applied would be equal to the average rate on the main refinancing operations conducted throughout the maturity of the operation. In addition, after the Italian and Spanish governments had announced new structural and fiscal measures, the Governing Council reactivated the SMP. Until that time, purchases had been concentrated in the weeks following the implementation of the programme, in May 2010, and from April to July 2011 the programme had been idle. Between August and December 2011, government paper amounting to € 137.5 billion was purchased, bringing the value of the portfolio of securities bought since entry into force of the programme – valued at the purchase price – to € 211.5 billion, or 7.7 % of the consolidated balance sheet of the Eurosystem.

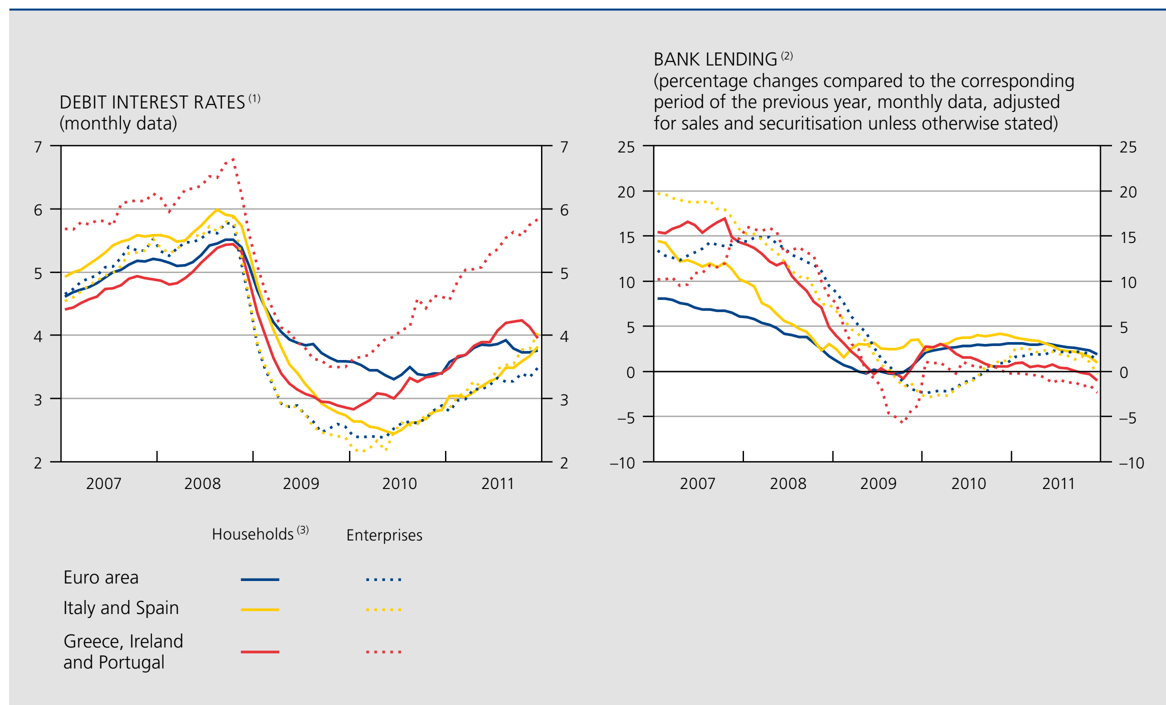
On 15 September, it was decided to conduct three additional liquidity-providing operations at three months in US dollars, in October, November and December 2011 respectively. Such operations already existed on a weekly basis, but in view of the increased difficulty for euro area credit institutions to obtain funding in dollars, it was deemed necessary to offer longer-term loans.

Box 2 – The recent transmission of monetary policy in the euro area

The contagion effects of the sovereign debt crisis had a direct impact on the balance sheets of banks in the euro area and weakened their liquidity and solvency positions. In these circumstances, the banks tended to limit lending and pass on the increase in their own funding costs in the interest rates on loans to households and non-financial corporations. Given the traditional national bias in the holding of sovereign bonds and the role of interest rates on government paper as a benchmark for setting other interest rates in the economy, this behaviour was particularly apparent in the countries at the heart of the sovereign debt crisis.

Thus, from the first wave of intensification of the sovereign debt crisis in the spring of 2010, there were some divergences in the transmission of monetary policy between euro area countries. For example, since that time, the interest rates on bank loans to both households and non-financial corporations have risen more steeply in Greece, Ireland and Portugal than in the rest of the euro area. They have also risen significantly in Italy and Spain since the summer of 2011, following the very marked contagion of the sovereign debt crisis in those two countries. Regarding the volume of loans, the intensification of the sovereign debt crisis seems to have had a greater restrictive impact in the countries most affected by the financial tensions. The average growth rates of lending to households and non-financial corporations in Greece, Ireland and Portugal followed a negative trend throughout 2010, whereas, at the same time, the growth of lending to the private sector in the euro area as a whole was increasing.

BANK FINANCING OF THE PRIVATE SECTOR IN THE EURO AREA



Sources: ECB, NBB.
(1) Rates offered on new loans, weighted by the amounts of the loans and by the GDP of the respective countries, taking all maturities together.
(2) Weighted by the GDP of the respective countries, data not adjusted for sales and securitisation before February 2010.
(3) Only interest rates on loans for house purchase.

The funding problems of credit institutions as a result of the sovereign debt crisis are not the sole cause of these developments, however. The weak growth of loans to the private sector in a number of countries in difficulty also reflects the general lack of confidence among economic agents and the sluggishness of economic activity. Moreover, it often compensates for past excesses which gave rise to a high level of debt in the private sector. As regards interest rates, some developments may also reflect the borrowing practices of the economic agents. For example, a higher propensity on the part of households or non-financial corporations to borrow at variable interest rates amplifies fluctuations in average rates, in both directions. In that respect, the wider variations in interest rates on loans to households in Italy and Spain must be interpreted with caution.

The sovereign debt crisis is a major challenge for the correct transmission of monetary policy in the euro area. In order to safeguard that transmission, the Governing Council set up a Securities Markets Programme in May 2010. It should be noted that while this programme has limited the effects of the sovereign debt crisis on the rest of the economy, it does not remove the causes, which should primarily be addressed by countries themselves.

In October, the Governing Council adopted a substantial package of new non-conventional measures. First, it decided to conduct two additional longer-term operations, one in October with a maturity of twelve months, and one in December for thirteen months, according to a procedure granting full allotment of the tenders at the average interest rate applied to the main refinancing operations throughout the term of the operations. The aim of this extension of the term for providing liquidity was to mitigate the banks' uncertainty over funding

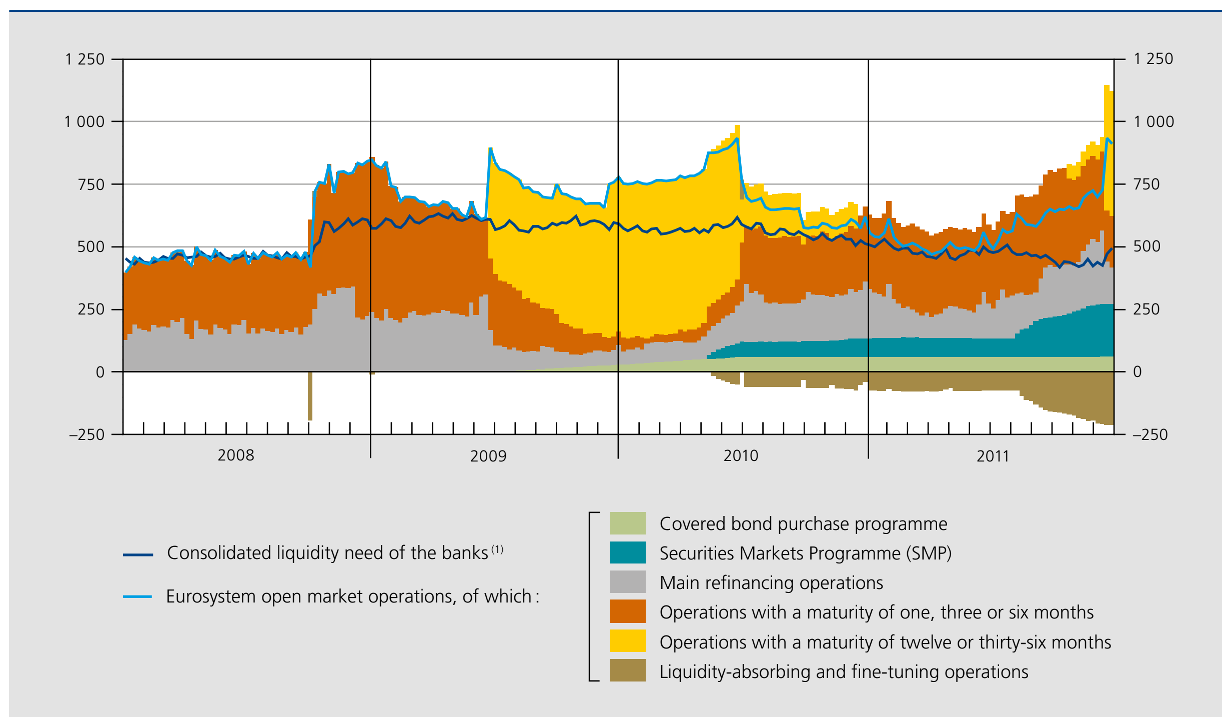
and thus encourage them not to stop lending to the economy. Next, the Governing Council announced that, until mid-2012, all refinancing operations would continue to be conducted with full allotment of the tenders and at a fixed interest rate. Finally, it was agreed to launch a second programme for the purchase of covered bonds. These securities were targeted because they represent a substantial source of funding for banks in the euro area, and the conditions on that market are thus a vital determinant of the banks' ability to lend to their customers. While the first purchase programme had led to the acquisition of a portfolio of covered bonds totalling € 60 billion between July 2009 and June 2010, the new plan made provision for purchases totalling € 40 billion over a one-year period beginning in November 2011.

On 30 November, the Bank of Canada, the Bank of England, the Bank of Japan, the ECB, the Federal Reserve and the Swiss National Bank announced a coordinated move to ease the tensions on the financial markets and thus moderate their influence on the supply of credit for the private sector. The central banks decided on a 50-basis-point cut in the interest rate applied under the existing temporary mutual currency exchange system (swaps in US dollars) to align it with the rate on overnight swaps (OIS) in dollars plus 50 basis points. The corresponding swap agreements were extended until 1 February 2013. In addition, the ECB and three other central banks will continue to grant three-month loans in dollars. Finally, as a precaution, it was decided to arrange temporary bilateral agreements concerning currency swaps, so that liquidity could be supplied in each territory in each currency if market conditions so required.

At its 8 December meeting, the Governing Council adopted a new series of non-conventional measures, as part of its continuing efforts to support bank liquidity and to facilitate the operation of the euro area's interbank market. First, it decided to conduct two longer-term refinancing operations with a maturity of 36 months, in December 2011 and February 2012, in accordance with the procedure for full allotment of the tenders, at the rate corresponding to the average interest rate on the main refinancing operations conducted during their respective terms. In order to give the banks more flexibility, these operations were also accompanied by an early repayment option after one year. The first operation, conducted in

CHART 23 CONSOLIDATED LIQUIDITY NEED AND EUROSYSTEM OPEN MARKET OPERATIONS (1)

(outstanding amounts at the end of the week, in € billion)



Source : ECB.

(1) Liquidity need due to "autonomous factors" such as demand for banknotes and reserve requirements. The difference between Eurosystem open market operations and this liquidity need is the liquidity surplus or deficit (–) on the money market. That corresponds to the net use of the standing deposit and marginal lending facilities by the banks, plus excess reserves.

December, replaced the 13-month operation announced in October, while banks were offered the option of transferring to this 36-month operation the whole of the amounts allotted under the 12-month operation conducted in October. This resulted in the allotment of € 489.2 billion and generated a net injection of liquidity in the order of € 210 billion. Next, the Governing Council wanted to extend the list of eligible collateral for the Eurosystem loans by lowering the rating threshold required for certain asset-backed securities (ABS) and allowing national central banks to accept as collateral bank loans which met specific eligibility criteria. Thirdly, the reserve ratio was cut from 2 to 1 % from the reserve maintenance period beginning on 18 January 2012, reducing the credit institutions' consolidated liquidity need and freeing up some of the assets that can be used as collateral for Eurosystem loans.

All these non-conventional monetary policy measures are intended to underpin financial intermediation in times of severe market tension. However, they do not offer a permanent solution to the financial problems facing countries or credit institutions. On the contrary, in the long term, they may have perverse effects in that, for the stakeholders concerned (banks and governments), they reduce the incentive to embark on the necessary balance sheet consolidation. Moreover, still in the long term, such measures combined with an accommodating monetary policy stance may fuel excessive risk-taking by economic agents and therefore have adverse effects on growth and price stability. Although these measures deal with some distortions, they are thus liable to create others if they are maintained for too long. In this connection, the Governing Council constantly reiterated that the measures were, by definition, of an exceptional and temporary nature.